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TREASURY FOR OFFICE OF EASTERN AND CENTRAL EUROPE

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SUBJECT: CYPRUS ECONOMY: SO FAR, BETTER THAN MOST

REF: A. 08 NICOSIA 759
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¶1. (SBU) Summary: Local economists expect the Cyprus economy to continue achieving slightly positive GDP growth this year despite being buffeted by the international economic crisis. A diversified economy, a generally stable real estate market, banks that avoided the excesses of those in money centers, a government that practiced strict fiscal and monetary conservatism in the run-up to its joining the Eurozone last year, and a populace that has eschewed stock market investing for most of this decade has put Cyprus in an enviable position relative to others in the EU and elsewhere despite the ongoing risks of further contagion. That said, key construction and toursim sectors are in decline and faceing challenging prospects for the foreseeable future. End Summary.

Construction Down

¶2. (SBU) The Cypriot economy is slowing markedly from the approximately 3.6 percent GDP growth achieved in 2008 (including an annualized 2.4 percent rate in Q4 2008) to an anticipated growth of 1-2 percent for 2009. Construction and real estate, which had been the leading contributors to Cyprus' rapid growth over the past few years, and comprised about 25 percent of GDP in 2007, began to slow considerably beginning Q4 2008. Land Registry figures indicate a 31 percent decline in real estate sales in 2008, largely concentrated in Q4, and due in particular to the exit of British buyers from the market. Construction activity is down 40 percent so far in 2009 compared to last year and building permits down 8 percent.

¶3. (SBU) According to the most widely used index, real estate values across Cyprus increased by 2.8 percent in 2008 following a 19.2 percent rise in 2007. However, prices reversed direction in Q4 2008 with values declining 1.5 percent. The biggest declines were in the tourist areas of Paphos and Agia Napa, districts where British and other foreign homebuyers comprise the majority of real estate purchasers. Sales volume has declined 70 percent in the Paphos district. With the fall of the British Pound against the Euro and the general financial distress in the UK, the British are not only no longer purchasing retirement and vacation homes in Cyprus, but many are trying to sell what they have. In cities such as Larnaca and Limassol, where Cypriots are the primary buyers of real estate, prices have not declined although the number of transactions are down more than 30 percent. Real estate values in Nicosia, where there is almost exclusively a domestic real estate market, are reportedly up 3 percent this year.

Banks Hanging On

¶4. (SBU) The decline in real estate has had limited effect on the banking sector. Non-performing loans from mortgage holders remain low (less than 2 percent) and given the glacial pace of the Cypriot judicial system, workouts of problem loans are more likely than foreclosures. The bigger concern is smaller developers who are highly leveraged and cannot afford to carry their inventory. A local banker told us that he expects loans to such companies to start failing by next month, but that most banks have already increased reserves for this eventuality. The larger developers tend to be less highly leveraged and to have sufficient cash flow from managing properties to allow them to sustain their bank payments.

¶5. (SBU) Local bank stocks have been hammered over the past year, down more than 40 percent. This is the result of foreign stock holders selling these assets to raise capital as well as some concern that Cypriot bank exposure to Eastern Europe, Russia and Greece could prove problematic even if Cyprus itself manages to escape negative growth. Bankers here tell us that their exposure to developing markets remains less than 8 percent of total assets and, so far, their businesses there continue to perform adequately due to conservative lending practices. Their exposure to the Greek market is more significant, about 30-40 percent of assets. However, the bankers say that their business is tracking with the growth of the overall Greek economy, and accordingly they are realizing slower growth but not losses in their Greek operations. The Cypriot banks with subsidiaries in Greece have declined access to GOG bailout funds saying that do not need the extra capital. For 2008, the three major Cypriot

banks, Bank of Cyprus, Marfin-Laiki, and Hellenic Bank, respectively realized a 4 percent net profit increase, a 30 percent decline, and a 75 percent decline, mostly the result of poor performance in their investment businesses and increases to loan loss reserves. The Central Bank also assures us that the banking system here is not experiencing much stress and that bank deposits from Russian or Russia-related businesses and individuals (about 45 percent of total deposits) remains unchanged from last year.

Word on the Street

¶6. (SBU) Anecdotally, although the restaurants and bars that cater to locals rather than tourists are as busy as ever, there has been a significant decline in economic activity. Car dealers tell us that their sales are down 25-40 percent from last year and car owners are more frequently taking their cars to independent garages rather than pay for the more expensive dealer servicing. The manager of Cyprus' largest travel agency said her sale of outbound tickets in January and February were 30 percent less than the same time last year because, "now is just not the right time to spend money on non-essentials." The Hotel Association reports bookings for this summer are down 20 percent. The editor of a major newspaper told us that his ad revenue has fallen more than 30 percent this year and he would have to begin laying off staff.

Unemployment Up, Slightly

¶7. (SBU) Unemployment is inching up, to 4.3 percent in January from 4.2 percent in December. This is the third lowest in the EU according to Eurostat, and economists here do not believe it will go much higher despite the likelihood of increasing layoffs in the hotel and construction sectors. This is because of the large number of foreign workers employed in Cyprus, estimated at more than 20 percent of the total workforce. In the construction sector, more than 26 percent of the workforce is foreign (and more than 40 percent if Turkish Cypriot construction workers employed in the south

are included). In the hotel and restaurant sector, more than 38 percent of workers are foreigners. Since these sectors are heavily unionized, and the Cypriot unions will protect Cypriot union members before foreign union members, expectations are that very few Cypriots will lose their jobs but many Sri Lankans, Filipinos, Bulgarians and Romanians may become unemployed over the next year.

How Does Cyprus Do it?

¶8. (SBU) There are several keys to Cyprus' relative success in escaping the worst ravages of the financial crisis:
-A large part of the population enjoys stable jobs and growing income by working for the government. About 15 percent of the population is employed by the state or a parastatal. These employees receive biannual cost of living adjustments and last year received an 8 percent base salary increase. With the current left wing government, there is no likelihood of any reduction in this staff. Ten percent of the workforce is employed by the large banks. These are heavily unionized, like the government workers receive a biannual COLA, and layoffs and salary reductions are unheard of. About 12 percent of Cypriots receive COLA-adjusted pensions. These pensions were recently increased by the government, especially for those at the lower end of the income scale.

-Cypriots have been largely absent from the global stock market since the local bourse crashed in 2000. Since then, property and bank CDs have been the investments of choice, with Cypriot land values doubling post-2002. Cypriots generally still feel wealthier than they did a few years ago, even as the constant drumbeat of bad global economic news has caused them to reduce their consumption levels, which had reached unsustainable rates in any case.

-Banks here have always funded themselves via deposits, not through the European interbank market, and they have utilized their funds through self-generated lending with no on-selling of the loans. Thus their exposure to exotic instruments and uncertain funding is very limited. Foreign currency deposits have a 70 percent reserve requirement. Loan/deposit ratios are very conservative at 85-90 percent.

Government Stimulus

¶9. (SBU) The government has promised a 300 million Euro stimulus package aimed primarily at the tourism and construction sectors. Landing fees have been reduced at the nation's airports and tour operators are being offered a reduction in VAT for their clients (from 8 to 5 percent). New construction projects, especially roads, schools and cultural centers, are expected to begin this year to help those construction companies no longer building vacation homes for British expatriates. Even with these increased expenditures, the government budget deficit is anticipated to be below 1 percent of GDP for this year and overall government debt to remain below 50 percent of GDP.

¶10. (SBU) Comment: There are some questions about the generally positive scenario in Cyprus: bank lending is down and credit harder to find, sales are dropping fast at retail establishments, and government is not particularly good at fast-tracking projects-so how can growth of any sort be achieved? And if the British economy that provides more than 50 percent of all tourists to Cyprus continues to decline, will the Cypriot tourism sector suffer more than expected? And with the trade deficit having grown by almost 17 percent in 2008 (and the deficit equal to 36.5 percent of GDP.) additional declines in services exports could make financing future imports more expensive. So far, however, it seems that with the banks apparently safe and with the GOC in a good position to provide more stimulus if needed, things in

Cyprus are as good as they are anywhere in the Eurozone despite the uncertainties.
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